Nos. 20,159-20,174

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

SEABOARD FINANCE COMPANY,
SEABOARD FINANCE COMPANY, TRANSFEREE,
SEABOARD FINANCE COMPANY OF LYNWOOD,
SEABOARD FINANCE COMPANY OF MONTEREY,
SEABOARD FINANCE COMPANY OF NORTHERN CALIFORNIA,
SEABOARD FINANCE COMPANY OF COLORADO SPRINGS,
SEABOARD FINANCE COMPANY OF DENVER, TWO,
SEABOARD FINANCE COMPANY OF DENVER, THREE,
SEABOARD FINANCE COMPANY OF DENVER, FOUR,
SEABOARD FINANCE COMPANY OF DENVER, FIVE,
SEABOARD FINANCE COMPANY OF PUEBLO, TWO,
SEABOARD FINANCE COMPANY OF CONNECTICUT, INC.,
SEABOARD FINANCE COMPANY (IDAHO),
SEABOARD FINANCE COMPANY OF TERRE HAUTE, INC.,
SEABOARD FINANCE COMPANY, INC. (MASSACHUSETTS),
SEABOARD FINANCE COMPANY OF FLINT,
Respondents

SEABOARD FINANCE COMPANY, ET AL.,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT
OF THE UNITED STATES

REPLY BRIEF FOR THE COMMISSIONER AS PETITIONER AND BRIEF FOR
THE COMMISSIONER AS RESPONDENT

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I N D E X

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REPLY BRIEF FOR THE COMMISSIONER AS PETITIONER AND BRIEF
FOR THE COMMISSIONER AS RESPONDENT 1/

1/ Pursuant to a stipulation (I-R. 143-145), Part I of this brief is the Commissioner's Reply to the Answering Brief of Taxpayers (Br. 14-47) and Part II of this brief is the Commissioner's Answering Brief to the arguments raised by taxpayers as cross-petitioners (Br. 48-54).

I

THE NET PREMIUM PAID BY TAXPAYERS IN ACQUIRING NUMEROUS SMALL LAON BUSINESSES WAS PAID FOR NON-AMORTIZABLE GOODWILL

In their brief (Br. 19), taxpayers have stated:

> Seaboard's position in this case can be summarized in a brief sentence -- Seaboard paid more than face value for the loan contracts because they were worth more than face value.

We agree. The contracts purchased in every transaction were worth more than their face value because each group of contracts was not only a group of unconditional promises to pay face value in money on a given date but was also a list of customers who were expected to enter into new contracts and thus provide a source of continued patronage. The evidence is undisputed that of the several value factors that underlay the payment of the premiums in question, the most significant was the prospect that the customers would refinance their contracts. The only question involved in this case is a legal one, namely, whether this Court was correct in holding that a payment for the "expectancy of continued patronage" is non-amortizable goodwill (Boe v. Commissioner, 307 F. 2d 339, 343), or whether the Tax Court was correct in permitting taxpayers to amortize the portion of the premium paid for "expectancy of continued patronage".

Taxpayers' reliance on the clearly erroneous rule (Br. 14-19) is simply an effort to obscure the real question involved. Neither the facts nor the inferences to be drawn from those facts

are in dispute. What is in dispute is the meaning of goodwill and the nature of goodwill as a non-amortizable asset. In Boe, supra, p. 342, this Court made it clear that when "the question is not, what are the facts, but what are the legal consequences of those facts", the issue is a legal one, not a factual one. 2/ Thus, the issue here is purely a legal one.

Taxpayers are in the business of lending money. As part of their program of expansion, taxpayers purchased the business (or in some cases, part of the business) of 55 small loan companies in various locations around the country. In each case, taxpayers examined the outstanding loan contracts of these companies and by a process referred to as spreading the accounts determined that they would pay the seller a premium above the face value of the assets. This is undisputed.

A loan contract is a borrower's promise to pay off a fixed sum of money at a given rate of interest by a fixed date. The various states regulate the maximum term (never more than 36 months) and maximum interest rate that could be provided in these contracts, but all states permit refinancing. Refinancing entails

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2/ In Boe, this Court was required to determine whether the Commissioner's position as to the meaning of goodwill (which is identical to the Commissioner's position in this case) was a legal issue because it was first raised after the trial; the fact that in this case the Tax Court rejected this Court's interpretation of goodwill has not suddenly converted that same question into a factual one.

(II-R. 132) "having the customer come to the office and executing documents, cancelling out the old documents, and, of course, the transactions based on lending him an additional amount of money." In spreading the accounts to determine the size of the premium they would pay, the major factor taken into account was the prospect of the various borrowers' refinancing their loans, i.e., whether they would execute new loans. As taxpayers' witness, Lide, testified, the difference between the A and A+ accounts was his guess as to the prospect ot renewal or refinance. (II-R. 229-230.) 3/

3/ This testimony was as follows (II-R. 229-230):

Q. Will you tell us in your own words what you do in spreading accounts.

A. Well, I take a columnar pad and head the columns; account number, last name, the balance of the account, and then the grading symbols -- A plus, A, B, C, D, and E under that; then we take each account and list it according to account number and balance; then study the facts pertaining to the account -- whether it is on the account card or substantiating files -- and classify it A plus if we deem it a premium account; A if we think that we will collect the balance on the account, but with little possibility of renewal; B if it represents a 75 percent evaluation, and that account will probably cause trouble to some degree in our collection follow-up -- which would be expensive -- probably represent the 25 per cent or the 25 per cent may be charged off.

Likewise, C would represent 50 per cent accounts where there is more collection activity involved and where the account will probably have to be chased by -- excuse the word chased, it is a common word in the industry -- followed up by a personal contact.

Q. An effort to collect?

A. An effort to collect and the D accounts would be those that we think have very little possibility of collecting anything out of, but if we do, it is possible about 25 per cent of the balance.

E accounts are apparent loss accounts.

This, too, is undisputed.

Thus, it is clear that in evaluating two contracts requiring a payment of $100 by December 31, one might be rated as A (no premium) and one A+ (involving a premium) not because of the risk involved or because of anything contained in the contract, but because in one case (A+) the other party to the contract was expected to be a source of one or more future contracts and in the other case (A) the borrower was expected only to pay off the contract without entering a new one. Of course, none of the customers was obligated to refinance (nor could they be under state law), and on an individual contract basis taxpayers' evaluators could never be certain that a particular borrower would refinance. 4/ However, their experience in past cases (equally borne out by the facts here) was that 60 percent of the customers as a group would refinance. (I-R. 49, II-R. 133.)

In short, the undisputed and indisputable evidence makes it clear that there are several value factors associated with the purchase of a group of loan contracts. Each group of contracts has value in and of itself because the contracts are promises to

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4/ Mr. Weidman made this clear (II-R. 205):

Q. Do you have any way of telling which account or which particular borrower will renew his loan?
A. We can't guarantee that a loan will be renewed.
Q. You just can't tell which borrower will renew or not in any particular time, can you?
A. No. We have to work on our experience.

pay a given amount of money at interest over a given period and each group of contracts also represents an active list of customers which experience shows can be expected to execute repeat contracts. Taxpayers' spreading of the accounts was a careful and experienced attempt to segregate these value factors (and risk factors), and the primary element underlying the payment of premiums was the taxpayers' expectation as to the significance of the low risk repeat business that each group of contracts purchased could be expected to generate. 5/ As taxpayers' brief points out (p. 32, heading D), "The prospect of refinancing is simply a valuable right accompanying a loan contract" (emphasis added); it is not part of the contract itself. The legal question in this case is whether this value factor is non-amortizable goodwill, as the Commissioner contends, or whether it is some form of wasting asset, as taxpayers contend.

The Commissioner submits that this legal issue has previously been considered by this Court and other courts in undistinguishable cases. See, e.g., Boe v. Commissioner, supra; United States Industrial Alcohol Co. v. Helvering, 137 F. 2d 511 IC.A. 2d);

5/ Other factors, such as the interest rate of the particular state involved and the existence of competing purchasers for a business (II-R. 89-92), were taken into account in determining the size of the premium percentage that would be paid for A+ accounts but these more general considerations are not a basis for differentiating between A and A+ accounts.

Thrifticheck Service Corp. v. Commissioner, 287 F. 2d 1 (C.A. 2d); and United Finance and Thrift Corp. of Tulsa v. Commissioner, 282 F. 2d 919 (C.A. 4th). However, before turning to a discussion of these cases, it seems appropriate to dispose of several minor points that have been raised by taxpayers.

First, it should be noted that, contrary to taxpayers' assertion (Br. 33), the Commissioner does not contend that the prospect of refinancing was the only value element underlying the premium payments. It was, however, the most significant value factor involved and the Tax Court's error in allowing the amortization of 70 percent of the premium was mainly attributable to its failure to realize that amounts paid for this element were non-amortizable.

We do recognize that taxpayers were also purchasing the ability to start as an established going concern in a new community and thereby save the considerable expense and difficulty attendant upon opening a new office without an established set of accounts. This going concern value, while different from goodwill, is nevertheless a non-amortizable value factor, as this Court has recently held in Cornish v. United States, 348 F. 2d 175.

On the other hand, taxpayers assert, without record citation, that (Br. 33) "because of the high interest rate and quality borrowers, such contracts would be worth a considerable premium even if the borrower did not refinance." This statement is directly contrary to the testimony of taxpayers' own witness, who stated that no pre-

mium would be paid for an account that offered "little possibility of renewal". (II-R. 229-230.) Indeed, throughout their brief, taxpayers have tried to create the impression that the high interest rate was one of the reasons for the payment of a premium. This is simply untrue. There is not one scintilla of evidence indicating that taxpayers were willing to accept an interest rate less than the maximum allowable under state law or that they ever loaned money at less than the maximum rate of interest.

Taxpayers are seeking to assimilate the testimony indicating that the maximum interest rate of a state was taken into account in determining the amount of premium as evidence bearing on the reason for the premium payments. This does not follow, for while it is clear that the prospect of repeat financing of accounts at 2-1/2 percent a month is less valuable than the prospect of the same accounts being refinanced at 3 percent a month, this does not change a premium paid for the prospect of refinancing into something else. Only if taxpayers were willing to lend money at less than the maximum amount allowable under the law would it be possible to suggest that the premium was attributable to the high interest rates on small loans. 6/ Taxpayers' references to the

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6/ Indeed, this is the fallacy of taxpayers' purported reliance (Br. 31) on Section 171's provision with respect to amortizable bond premiums. That section is predicated on a recognition that a corporation, or even the Government, may float a bond issue in a year when the interest rate is five percent. Several (Continued)

high interest rates paid on small loan contracts thus seem simply an attempt to make the legal question submitted to the Tax Court appear to be a factual question only.

This same form of argument would also seem to underlie taxpayers' statement that (Br. 26)--

> The Commissioner has not in this appeal contended that the trial court wrongly determined that the value of the payments in question, including that portion if any which was paid for the prospect that the loans would be refinanced, would be exhausted in three or five years.

This is precisely the Commissioner's argument. The premium was paid, not for the contracts themselves, but primarily for what taxpayers have called (Br. 32, heading D) "a valuable right accompanying a loan contract". This severable asset, which taxpayers themselves have segregated on their books, is goodwill, and, as this Court held in Boe v. Commissioner, supra, it does not depreciate or wear out as specific loan contracts are renewed or paid off.

6/ (Continued) years later, the interest rate for a bond with that degree of safety may go down to four percent but the bond coupons will continue to pay cash equal to five percent of the face amount. The market will reflect the new lower interest rate by increasing the price of the bond (premium) so that the annual cash paid (although still five percent of face value) will yield an effective rate of four percent. Thus, a purchaser is permitted to amortize the premium so as to reflect the fact that only part of the annual interest payment represents interest to him and the balance really is a return of capital. In this case, however, none of the premium was attributable to taxpayers' willingness to accept less than the maximum rate of interest and there is no evidence to support any claim that the premium was paid because of the high interest rates.

In Boe, as part of the purchase of a contract medical practice, the purchasers allocated $270,042.81 to the outstanding 8,984 contracts. The issue on appeal was whether the cost of these contracts represented non-amortizable goodwill, as the Commissioner contended, or whether their cost could be deducted as individual contracts were cancelled or not renewed. It should be noted that taxpayers' position in Boe was far stronger than taxpayers' position here because taxpayers were not there claiming the right to amortize the cost of the contracts over any particular period but were only seeking to deduct the costs as contracts were actually terminated.

This Court noted that these contracts, while unenforceable, represented a list of customers who were expected to continue to patronize the practice. So here, Seaboard had no assurance that any loan contract would be renewed (II-R. 205), and, indeed, the various state laws would not permit an enforceable contract providing for a term longer than 36 months and some states had shorter terms. But, as this Court stated (307 F. 2d 339, 342-343)--

> * * * the contracts, though terminable at will, gave sufficient assurance of continued patronage to taxpayer and his associates that they were willing to pay a large sum for Dr. Callison's practice. We have defined good will as "the sum total of those imponderable qualities which attract the custom of a business" (Grace Bros. v. Commissioner, 9 Cir., 1949, 173 F. 2d 170, 175-176). We there pointed out that good will may attach to the number and quality of the customers of the business. To us, the essence of good will is the expectancy of continued patronage, for whatever reason.

Moreover, although taxpayers in Boe conceded that goodwill is not a depreciable asset, this Court did not unquestioningly accept that concession. It went on to explain why the purchaser of a customer list could not deduct a portion of the cost of that list as individual customers on the list ceased to continue their patronage by quoting Judge Goodman's statement in National Metropolitan Laundry Co. v. United States, 100 F. Supp. 803, 805 (N.D. Cal.), that (307 F. 2d 339, 343)--

> "The gradual replacement of old patrons with new ones is not to be regarded as the exchange of old capital assets for new and different ones, but rather as the process of keeping a continually existing capital asset intact."

This is precisely the Commissioner's position here. As we have seen, the most significant value factor for which the premium was paid was the prospect that existing patrons would renew their contracts. This is goodwill, and while we agree that the average customer would "run off" the books at the end of three to five years, the goodwill element is not regarded as attributable to any particular contract or group of contracts and may not be amortized or deducted simply because old customers are replaced by new ones.

Indeed, the validity of Judge Goodman's analysis of the nature of goodwill as a continuing, non-amortizable asset can be demonstrated in a slightly different way. Even if we assume that at the end of five years every single one of the customers whose

contracts taxpayers had purchased at a premium had gone off taxpayers' books, 7/ this would not mean that taxpayers had no goodwill. Quite the contrary, the gradual replacement of the old customers with new ones is the process by which that asset is kept intact, and we can expect that if Seaboard chose to sell its office to another loan company at the end of such a five-year period, the particular contracts then on hand would continue to command a premium because of the anticipated prospects of refinancing.

This, too, is the thrust of Judge Hand's comments in United States Industrial Alcohol Co. v. Helvering, 137 F. 2d 511, 513-514 (C.A. 2d):

> In such an industry -- for that matter, in any industry -- continuity of sales is a condition of continued existence; once they stop, it is extremely hard, if not impossible, to start up the business again. Therefore the power to sell over the period immediately after the business is taken over, insuring as it does against such a break, has a value quite independent of any profit that may be got from those particular sales. There is no reason to suppose in the case at bar that the taxpayer would have paid anything whatever for the contracts if they had not contributed in this way to the continued existence of the business.

7/ This assumption is itself inaccurate because the record shows that while only 60 percent of the outstanding accounts during any period would be refinanced (i.e., those that do not go off the books), between 25 and 30 percent of the remaining accounts were former borrowers who had gone off the books for a period and then negotiated new loans. (II-R. 176.)

Taxpayers' efforts to distinguish these and other cases, which they lump under the rubric of the "indivisible asset" rule (Br. 38-46), stems from a failure to recognize that these cases are not based on any technical conceptions with respect to the burden of proof but on a basic analysis of the nature of goodwill as the prospect of continued patronage that is independent of the particular individuals who make up a firm's customer list at any given moment.

Thus, taxpayers here assert that the result in Boe would have been different if taxpayer had shown (Br. 42) "that he made an effort to value them [the medical contracts] individually * * *." Is this so? This Court stated that the decision in Boe was not based on a failure of proof; and, more important, why should the rules be different simply because taxpayers here made a more detailed effort to value the components of goodwill? To be sure, taxpayers in this case did examine the contracts to determine which ones exhibited a prospect of continued patronage, but this did not change what they were purchasing or the reason for their payment of a premium. 8/ "The essence of goodwill is the expectancy of con-

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8/ Indeed, Mr. Weidman tesitifed (II-R. 201) that it is impossible to allocate any portion of the premium to any particular loan account and, of course, the premiums at issue are the net premiums, i.e., reduced by the discount received on those contracts reflecting high risks of non-collectibility.

tinued patronage" (Boe v. Commissioner, supra), and all that taxpayers accomplished by spreading the accounts was the ability to make a far more accurate valuation of the worth of goodwill than is usually possible in other industries.

Indeed, the suggestion that the result in Boe would have been different if the purchasers had troubled to go through each one of the 8,984 contracts to determine the age and the degree of use, etc., that could be expected from each of the contracting patients seems completely inconsistent with this Court's description of goodwill as an asset that is kept intact by a continual process of change. Although the expectancy of patronage must come from existing patrons, it does not diminish as those patrons are replaced with new ones. Moreover, if taxpayers' position is to be sustained, we can expect a great volume of future litigation as purchasers of businesses seek to convert payments for goodwill into amortizable assets by the simple expedient of examining the customer structure of the businesses they are about to purchase so that they can allocate their goodwill payments on a customer-by-customer basis.

The other distinction advanced by taxpayers, based on the nature of the assets involved, is equally untenable. Taxpayers state that (Br. 41) "Seaboard purchased contracts calling for a 'determinable amount of income' over an 'ascertainable period'." If by this

statement they mean to imply that the purchased contracts were for stated amounts over terms running from three to five years, this is not true. No contract could possibly extend for more than 36 months, the maximum term permitted by any state laws, and since they were all existing contracts, the average term (exclusive of refinancing) must have been considerably less than 36 months. The record makes it indisputably clear that the premium was not paid for the value inherent in the existing contract terms but because of the expectancy that the various contracting borrowers would enter into one or more new contracts. Each contract had value in itself because it was a promise to pay money and each group of contracts had value because they represented an active list of customers that experience indicated would enter new contracts. In spreading the accounts, taxpayers made it clear that the latter value of the contracts (their value as a customer list) was severable from the contracts and that they were limiting the payment of a premium (the difference between the A and A+ contracts) to those contracts whi h their experienced evaluators determined were most likely to be the source of repeat business. In short, the cases relied on by the Commissioner cannot be distinguished on the ground that they involved assets (Taxpayers' Br. 41) "like customer lists and * * * contracts which in practical effect are like customer lists" because that is exactly what is

involved here. Each contract was not only a contract but one name in a customer list.

The Tax Court's legal error stemmed from its acceptance of the same erroneous legal arguments and distinctions advanced by taxpayers to this Court. The Tax Court thought that the issue was whether the amounts involved were "premiums paid on purchased loan contracts" or "goodwill" (I-R. 106) and concluded that 70 percent of the amount involved was attributable to premiums. The point that the Tax Court failed to grasp is that the premiums are payments for goodwill because, in addition to the other factors underlying Seaboard's decision to purchase (such as avoidance of start-up costs and other going concern elements), the most significant value factor underlying the payment of a premium was that the contracts were an active list of customers that were an anticipated source of future patronage.

The Tax Court purported to distinguish the cases (Boe, supra; Thrifticheck Service Corp., supra; and United States Industrial Alcohol Co., supra) relied upon by the Commissioner on exactly the same grounds (nature of asset and proof of detailed valuation of the prospect of repeat business) that the taxpayers press upon this Court. If, as we submit, those cases represent a correct and comprehensive analysis of the nature of goodwill, then they are not distinguishable from the instant case, and the Tax Court's

error in failing to apply the rule of law they announce is unquestionably a legal, rather than factual, error.

In sum, the undisputed and indisputable evidence shows that in addition to their value as a group of contractual promises to pay money, each group of contracts was also valuable because it represented a list of active customers who were expected to be a source of future contracts. Taxpayers' experienced evaluators segregated these value elements, and their value as a potential source of repeat business was the most significant factor underlying the premium payments in question. Under the decisions of this Court and other courts, a payment for the "expectancy of continued patronage" is a purchase of goodwill, an intangible asset that does not depreciate as old patrons are replaced by new ones. Accordingly, the Tax Court erred in permitting the taxpayers to deduct the price paid for the severable goodwill elements that accompanied the contracts purchased over the life of the contracts (plus estimated period of refinance).

II

TAXPAYERS' CROSS-PETITION FOR REVIEW

Taxpayers' arguments as cross-petitioners are in substance protective arguments urged only in the event that this Court agrees with the Commissioner that the question is a factual one. However, we submit that if this Court agrees that the Tax Court

misunderstood the nature of goodwill and erroneously distinguished undistinguishable precedents of this Court and other courts, of necessity a remand for entry of decision in favor of the Commissioner is required. 9/

CONCLUSION

The decision of the Tax Court should be affirmed insofar as it held that 30 percent of the net premiums in issue were attributable to the purchase of non-amortizable goodwill and going concern value.

Respectfully submitted,

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JANUARY, 1966.

9/ We do wish to point out that A.R.M. 34, 2 Cum. Bull. 31 (1920), has no application to the purchase of assets that are in substance customer lists.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ______________________ day of __________________, 1965.

____
FRED R. BECKER
Attorney